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No. 95-1677

In the Supreme Court of the United States

OCTOBER TERM, 1995

FRANCIS LEVIEN AND JANICE LEVIEN, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether petitioner is "at risk" with respect to a long-term note that he executed in a circular sale-leaseback of computer equipment and is therefore allowed to take deductions in excess of his cash investment under Section 465 of the Internal Revenue Code, 26 U.S.C. 465.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-2a) is unofficially reported at 77 A.F.T.R.2d (RIA) 96-1009 and is noted at 77 F.3d 497 (Table). The opinion of the Tax Court (Pet. App. 3a-27a) is reported at 103 T.C. 120.

JURISDICTION

The judgment of the court of appeals was entered on January 22, 1996. The petition for a writ of certiorari was filed on April 16, 1996. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

1. In December 1983, Aardan Leasing Corporation acquired certain computer equipment in two transactions. Aardan acquired some of the equipment from Equilease Associates III Limited Partnership (Associates) and the remainder of the computer equipment from Equilease Equipment Brokerage C.V. (C.V.). In each transaction, Aardan paid part of the purchase price in cash and delivered a note for the balance. Aardan acquired the equipment subject to (i) the liens created when Associates and C.V. purchased the equipment and (ii) the leases of the equipment that had been entered into with end-users. Pet. App. 6a-7a. The computer equipment originally had been purchased with nonrecourse financing. *Id.* at 12a.

Simultaneously with these transactions, petitioner Francis Levien purchased an interest in the computer equipment from Aardan for a total consideration of $543,750.[1] Petitioner paid cash of $11,250 and executed two short-term notes in the amount of $21,875 each and one long-term note in the amount of $488,750. Petitioner's personal liability under the long-term note was limited to $325,000. Pet. App. 5a-6a. At the same time, petitioner (together with the other owners of interests in the equipment) leased the equipment back to Associates and C.V. The lease agreements provided fixed monthly rental payments for the terms of the leases and provided that Associates and C.V. would indemnify petitioner from any loss. *Id.* at 7a-8a, 13a.

Simultaneously with these transactions, petitioner entered into an agreement with Aardan to secure

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[1] Petitioner Janice Levien is a party because she filed joint income tax returns with her husband for the years in issue.

payment on his notes to Aardan. Petitioner gave security interests to Aardan in his interest in the computer equipment and his rights under the lease agreements with Associates and C.V. This included the right to collect the rent due under those agreements. The obligations of Associates and C.V. to pay rent to petitioner were secured by assignments of their rights to collect rent from their own sublessees. Pet. App. 8a.

Simultaneously with these transactions, petitioner and Equilease Corp., an affiliate of Associates and C.V., entered into two "Capitalization Agreements" under which Equilease agreed "to make all necessary loans, advances or capital contributions to C.V. and Associates, respectively, to ensure the payment by C.V. and Associates" of rents to petitioner. Pet. App. 8a. The monthly rental payments due to petitioner from Associates and C.V. precisely equalled the obligation of petitioner to pay Aardan for the computer equipment. That sum also equalled Aardan's monthly obligations to pay Associates and C.V. for petitioner's interest in the equipment. Similarly, the monthly rental payments due to petitioner from C.V. and Associates equalled the monthly payments that he was obligated to make to Aardan on the long-term note. *Id.* at 9a.

2. Petitioner claimed deductions from the equipment leasing transactions on his income tax returns for 1983 and 1984. The Commissioner determined that petitioner's deductions were limited by Section 465 of the Internal Revenue Code, which generally provides that a taxpayer may deduct a loss from an activity only to the extent that he is "at risk" for that activity. Section 465(d) defines "loss," for purposes of the Section, as the excess of allowable deductions

allocable to an activity over the income from such activity.

3. Petitioner sought review of the resulting deficiencies in the Tax Court. The Tax Court, in a reviewed opinion with no dissent, concluded that petitioner was not "at risk" (within the meaning of Section 465) with respect to the long-term note to Aardan because that obligation was "protected against loss through nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements." 26 U.S.C. 465(b)(4). The Tax Court stated that, in determining whether a taxpayer is protected against loss within the meaning of Section 465(b)(4), "we look to see whether there is any realistic possibility that the taxpayer ultimately will be subject to economic loss on the investment at issue." Pet. App. 10a. The Tax Court rejected petitioner's contention that the "worst-case scenario," rather than economic reality, must be considered in applying Section 465(b)(4). Pet. App. 13a-14a.

The Tax Court determined that the nonrecourse underlying debt, the circular, matching debt obligations, and the indemnification provided to petitioner, constituted an "arrangement" under Section 465(b)(4) of the Code by which petitioner was effectively protected against loss in connection with his debt. The Tax Court noted that all monthly obligations were exactly offset (including the rental obligations of Associates and C.V. to petitioner and the other owners, petitioner's obligations to Aardan, and Aardan's obligations to Associates and C.V.) and that the payments were mutually extinguished by offsetting bookkeeping entries. Pet. App. 12a. The court observed that the transaction was circular, with a middle entity (Aardan) connecting petitioner and the

third-party lessees (Associates and C.V.). *Ibid.* The court concluded that it was "highly unlikely that any one of the parties would refuse to meet an obligation" since, "if one party failed to 'pay', he could only expect a chain reaction resulting in his obligor's ceasing 'payment' as well." *Ibid.* The court noted that the rental payments of Associates and C.V. were guaranteed by an affiliate, Equilease, and the underlying financing used by the companies from whom Associates and C.V. purchased the computer equipment was nonrecourse. *Ibid.* Because petitioner was "effectively immunized from any realistic possibility of suffering an economic loss even though the underlying transaction was not profitable," the Tax Court concluded that petitioner was "protected against loss within the meaning of section 465(b)(4)." Pet. App. 14a.[2]

4. The court of appeals affirmed (Pet. App. 1a-2a). The court of appeals found itself in agreement with the reasoning of the Tax Court and affirmed the Tax Court's judgment "for substantially the reasons set out in its opinion." *Id.* at 2a.

ARGUMENT

The decision of the court of appeals is correct. Although the Sixth Circuit reached contrary decisions in *Emershaw* v. *Commissioner*, 949 F.2d 841 (6th Cir. 1991), and *Martuccio* v. *Commissioner*, 30 F.3d 743 (6th Cir. 1994), there is no need for this conflict to be resolved because the importance of "at risk" analysis

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[2] The Tax Court also determined that the leasing transaction was tax-motivated and that an increased rate of interest on the underpayment was therefore required by 26 U.S.C. 6621(c). Pet. App. 14a-15a.

under Section 465 has been substantially diminished by subsequent congressional enactment.

1. In 1976, Congress added Section 465 to the Internal Revenue Code to combat increasing abuse of tax benefits derived from the use of nonrecourse financing. See Tax Reform Act of 1976, Pub. L. No. 94-455, § 204(a), 90 Stat. 1531; S. Rep. No. 938, 94th Cong., 2d Sess. 45-51 (1976). Congress determined that the use of nonrecourse financing and other risk-limiting devices presented significant tax abuses, for they permitted taxpayers to deduct amounts in excess of their bona fide investment at risk in the transaction. See *id.* at 47.

In order to prevent taxpayers engaged in certain activities from deducting losses in excess of their actual economic investment in the activity, Section 465(a)(1) provides that a taxpayer engaged in an activity to which Section 465 applies may deduct a loss from that activity "only to the extent of the aggregate amount with respect to which the taxpayer is at risk * * * for such activity at the close of the taxable year." 26 U.S.C. 465(a)(1). A taxpayer's amount "at risk" with respect to an activity is generally the amount that he "could actually lose from th[e] activity." H.R. Rep. No. 1445, 95th Cong., 2d Sess. 67 (1978). A taxpayer is generally considered "at risk" to the extent of the cash and the adjusted basis of property contributed to the activity (26 U.S.C. 465(b)(1)(A)), as well as any amounts borrowed for use in the activity to the extent that the taxpayer "is personally liable for the repayment of such amounts." 26 U.S.C. 465(b)(2)(A). See S. Rep. No. 938, *supra*, at 49. Under Section 465(b)(4) of the Code, however, a taxpayer is not considered at risk with respect to "amounts protected against loss through

nonrecourse financing, guarantees, stop loss agreements, or other similar arrangements." 26 U.S.C. 465(b)(4). See S. Rep. No. 938, *supra*, at 49-50.

The Tax Court (Pet. App. 10a-14a) and the court of appeals (*id.* at 1a-2a) correctly determined in this case that Section 465(b)(4) applies to any mechanism or arrangement that has the effect of immunizing the taxpayer from economic losses from the venture. Because of the circular, offsetting sales and leases in the present case—under which Associates and C.V. were both the initial obligees (on the notes from Aardan) and the ultimate obligors (on the lease from petitioner and other interest owners)—the financial viability of the transaction was not in any manner dependent on Associates' and C.V.'s rental payments to petitioner. Indeed, because of Associates' and C.V.'s dual roles—which resulted from a series of interrelated transactions that occurred on the same day—Associates, C.V., Aardan, and petitioner could continue to satisfy their circular monthly obligations through offsetting bookkeeping entries. Because no cash needed to change hands, Associates, C.V., Aardan, and petitioner could continue to satisfy their respective monthly obligations by means of these offsetting obligations even if the underlying leases to end-users of the equipment were defaulted. The circular, offsetting nature of these obligations, Associates' and C.V.'s agreement to indemnify petitioner, Equilease's guarantee of the rent payments due petitioner, and the nonrecourse nature of the underlying debt, all effectively removed any realistic possibility that petitioner would suffer an economic loss from the transaction. Pet. App. 10a-14a.

Three other courts of appeals—the Ninth Circuit in *American Principals Leasing Corp.* v. *United*

States, 904 F.2d 477 (9th Cir. 1990), the Eighth Circuit in *Moser* v. *Commissioner*, 914 F.2d 1040 (8th Cir. 1990), and the Second Circuit in *Waters* v. *Commissioner*, 978 F.2d 1310 (2d Cir. 1992), cert. denied, 507 U.S. 1018 (1993)—have reached the same conclusion reached by the Eleventh Circuit in this case and in *Young* v. *Commissioner*, 926 F.2d 1083 (11th Cir. 1991). Those courts have also held that Section 465(b)(4) applies to any arrangement that effectively immunizes the taxpayer from incurring loss. In those cases, the courts were faced with three-party circular sales and leasebacks of computer equipment that were essentially the same as the transaction involved in the present case. All of these courts concluded that the taxpayers involved were not "at risk" because there was no realistic possibility that the taxpayers would be required to satisfy their notes. In reaching this conclusion, each of the courts emphasized that the circular, offsetting nature of the obligations ensured that the taxpayers would never be required to satisfy personally their respective obligations. See *Waters* v. *Commissioner*, 978 F.2d at 1317; *Young* v. *Commissioner*, 926 F.2d at 1089; *Moser* v. *Commissioner*, 914 F.2d at 1049; *American Principals Leasing Corp.* v. *United States*, 904 F.2d at 483. See also *Thornock* v. *Commissioner*, 94 T.C. 439 (1990).

2. Petitioners correctly note (Pet. 5-6) that in *Emershaw* v. *Commissioner*, 949 F.2d 841 (6th Cir. 1991), the Sixth Circuit interpreted Section 465(b)(4) to deny "at risk" treatment for a transaction only when a "collateral agreement" has been made with a third party who is a stranger to the transaction that protects the taxpayer from loss *after* the losses have occurred. See *Emershaw* v. *Commissioner*, 949 F.2d

at 849. In *Martuccio* v. *Commissioner*, 30 F.3d 743 (6th Cir. 1994), the Sixth Circuit followed *Emershaw* in another situation involving similar facts. As the Second Circuit concluded in *Waters* v. *Commissioner*, 978 F.2d at 1316, the Sixth Circuit's interpretation of Section 465(b)(4) is contradicted by the plain language of the statute, which refers to "nonrecourse financing" and "other similar arrangements" (26 U.S.C. 465(b)(4)). As the court stated in *Waters*, "nonrecourse financing" is "ordinarily a *prearrangement* to protect against loss." 978 F.2d at 1316.

The Sixth Circuit's interpretation of the statute is also contrary to the fundamental premise of Section 465, which is that a taxpayer's deductions should be limited to the investment for which he is "at risk" (26 U.S.C. 465(a)). The object of the statute is "[t]o prevent a situation where the taxpayer may deduct a loss in excess of his economic investment." S. Rep. No. 938, *supra*, at 48. The Sixth Circuit erred in *Emershaw* by placing emphasis on the statement in the Senate Report that "an investor is not 'at risk' if he arranges to receive insurance or other compensation for an economic loss after the loss is sustained, or if he is entitled to reimbursement for part or all of any loss by reason of a binding agreement between himself and another person" (S. Rep. No. 938, *supra*, at 49). See 949 F.2d at 848-849. As the Second Circuit stated in *Waters*, "[w]hile the Senate Report outlines some arrangements that fall within § 465(b)(4), it does not directly address the language of that provision or purport to provide an exhaustive description of its coverage." 978 F.2d at 1316.

Petitioners contend (Pet. 6-7) that the court of appeals erred in disregarding the "worst-case scenario" test articulated by the Sixth Circuit in *Emer-*

shaw, *i.e.*, the potential insolvency or bankruptcy of Associates and C.V. The Senate Report, however, indicates that the possibility that the party protecting the taxpayer against loss "will fail to carry out the agreement (because of factors such as insolvency or other financial difficulty) is not to be material unless and until" the time such event occurs. S. Rep. No. 938, *supra*, at 50 n.6. For this reason, courts have correctly rejected the suggestion that the "worst-case scenario," instead of economic reality, should be the guide in determining whether the taxpayer is "at risk" for purposes of Section 465. See *Waters* v. *Commissioner*, 978 F.2d at 1317; *Young* v. *Commissioner*, 926 F.2d at 1089; *Moser* v. *Commissioner*, 914 F.2d at 1049; *American Principals Leasing Corp.* v. *United States*, 904 F.2d at 482.

3. The importance of the question presented in this case has been substantially diminished by subsequent legislation. In 1986, Congress added Section 469 to the Internal Revenue Code to eliminate the benefits of many traditional tax shelters. See Tax Reform Act of 1986, Pub. L. No. 99-514, § 501(a), 100 Stat. 2233; S. Rep. No. 313, 99th Cong., 2d Sess. 713-718 (1986). Effective for tax years beginning after December 31, 1986, Section 469 generally provides that losses from a "passive" trade or business activity are deductible only against income from that or another passive activity, and cannot be deducted against other income, such as salary, interest, dividends, and active business income. See S. Rep. No. 313, *supra*, at 718-719, 722; 26 U.S.C. 469(a). A "passive activity" is an activity "in which the taxpayer does not materially participate" and which involves the conduct of a trade or business. 26 U.S.C. 469(c)(1). While Section 465 was designed to combat one of the significant features

of the traditional tax shelter, the passive-loss limitations of Section 469 respond directly to the sheltering of income and prevent a taxpayer from reducing taxes on income from one source with losses and excess credits from another source.

The Section 469 passive-loss limitations are broader in scope than those of Section 465 and have effectively displaced analysis under that Section. Even if a taxpayer is considered to be "at risk" with respect to an investment, a loss may be claimed only to the extent that it is allowed by Section 469. See Staff of Joint Comm. on Taxation, 100th Cong., 1st Sess., *General Explanation of the Tax Reform Act of 1986*, at 223 & n.17 (Comm. Print 1987); 26 C.F.R. 1.469-2T(d)(6). For tax years beginning after 1986, the passive-loss limitations thus bar deductions of the type involved in the present case *regardless* of whether the taxpayer is "at risk." The question addressed in this case, and in *Emershaw*, would thus be inconsequential with respect to an identical transaction entered into after December 31, 1986.[3]

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[3] We note that the Court accordingly denied certiorari in *Waters* v. *Commissioner*, 507 U.S. 1018 (1993), notwithstanding the conflict between that decision and *Emershaw*.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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